5

Internal Reconstruction

Learning Objectives

After studying this chapter, you will be able to:

- ♦ Understand the meaning of term "reconstruction".
- ♦ Sub-divide and consolidate shares.
- ♦ Convert shares into stock and stock into shares.
- ♦ Account the adjustments made at the time of internal reconstruction.

1. Meaning of Reconstruction

When a company has been making losses for a number of years, the financial position does not present a true and fair view of the state of the affairs of the company. In such a company the assets are overvalued, the assets side of the balance sheet consists of fictitious assets, useless intangible assets and debit balance in the profit and loss account. Such a situation does not depict a true picture of financial statements and shows a higher net worth than what the real net worth ought to be. In short the company is over capitalized. Such a situation brings the need for reconstruction.

Reconstruction is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered by reducing the paid up value of shares and/or varying the rights attached to different classes of shares. The object of reconstruction is usually to reorganize capital or to compound with creditors or to effect economies. Such a process is called ***internal reconstruction*** which is carried out without liquidating the company and forming a new one.

However, there may be external reconstruction. Wherever an undertaking is being carried on by a company and is in substance transferred, not to an outsider, but to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company, there is external reconstruction. Such external reconstruction is essentially covered under the category 'amalgamation in the nature of merger' in AS-14.

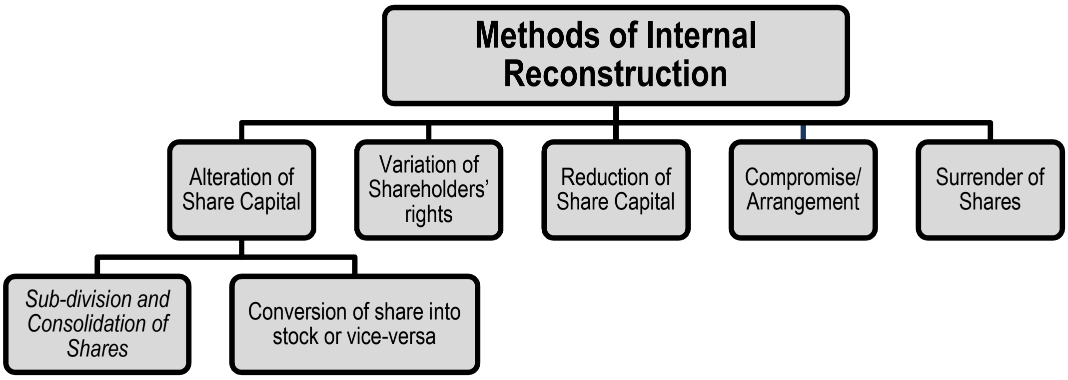
1.1 Difference Between Internal and External Reconstruction

Basis	Internal Reconstruction	External Reconstruction
Liquidation	The existing company is not liquidated.	The existing company is liquidated.
Formation	No new company is formed but only the rights of shareholders and creditors are changed.	A new company is formed to take over the liquidated company.
Reduction of capital	There is certain reduction of capital and sometimes the outside liabilities like debenture holders may have to reduce their claim.	There is no reduction of capital. In fact there is a fresh share capital of the company.
Legal position	Internal reconstruction is done as per provisions of section 100 of the Companies Act, 1956*.	External reconstruction is regulated by section 394 of the Companies Act, 1956*.

** The corresponding sections under Companies Act, 2013 related with these sections have been not been notified till 31st May, 2015.*

2. Methods of Internal Reconstruction

For properly deploying the process of internal reconstruction following methods are generally employed or used simultaneously:



2.1 Alteration of Share Capital

Sub-division and Consolidation of Shares

If authorised by its Articles, a company may, in a general meeting by passing an ordinary resolution, decide to sub-divide or consolidate the shares into those of a smaller or higher denomination than that fixed by the Memorandum of Association, so long as the proportion

between the paid up and unpaid amount, if any, on the shares continues to be the same as it was in the case of the original shares.

A notice specifying alteration made must be given to the Registrar within 30 days of alteration.

For example, a company with a capital of ₹ 10,00,000 divided into 10,000 equity shares of ₹ 100 each on which ₹ 75 is paid up decides to recognise its capital by splitting one equity share of ₹ 100 each into 10 such shares of ₹ 10 each. The consequential entry to be passed in such a case would be—

		Dr.	*Cr.*
		₹	₹
Equity Share Capital (₹ 100) A/c	Dr.	7,50,000	
To Equity Share Capital (₹ 10) A/c			7,50,000
(Being the sub-division of 10,000 shares of ₹ 100 each with ₹ 75 paid up thereon into 1,00,000 shares of ₹ 10 each with ₹ 7.50 paid up thereon as per the resolution of shareholders passed in the General Meeting held on...)			

Similar entries will be passed on consolidation of shares of a smaller amount into those of a larger amount.

Illustration 1

On 31-12-2012, B Ltd. had 20,000, ₹ 10 Equity Shares as authorised capital and the shares were all issued on which ₹ 8 was paid up. In June, 2013 the company in general meeting decided to *sub-divide* each share into two shares of ₹ 5 with ₹ 4 paid up. In June, 2014 the company in general meeting resolved to *consolidate* 20 shares of ₹ 5, ₹ 4 per share paid up into one share of ₹ 100 each, ₹ 80 paid up.

Pass entries and show how share capital will appear in notes to Balance Sheet as on 31-12-2012, 31-12-2013 and 31-12-2014.

Solution

Journal Entries

2013			₹	₹
June	Equity Share Capital (₹ 10) A/c	Dr.	1,60,000	
	To Equity Share Capital (₹ 5) A/c			1,60,000
	(Being the sub-division of 20,000 shares of ₹ 10 each with ₹ 8 paid up into 40,000 shares ₹ 5 each with ₹ 4 paid up by resolution in general meeting dated....)			

2014 June	Equity Share Capital (₹ 5) A/c	Dr.	1,60,000	
	To Equity Share Capital (₹ 100) A/c			1,60,000
	(Being consolidation of 40,000 shares of ₹ 5 with ₹ 4 paid up into 2,000 ₹ 100 shares with ₹ 80 paid up)			

Notes to Balance Sheet

Liabilities:	₹
As on 31-12-2012	
1. Share Capital	
Authorised:	
20,000 Equity Shares of ₹ 10 each	2,00,000
Issued and Subscribed:	
20,000 Equity Shares of ₹ 10 each ₹ 8 per share called up	1,60,000
As on 31-12-2013	
1. Share Capital	
Authorised:	
40,000 Equity Shares of ₹ 5 each	2,00,000
Issued and Subscribed:	
40,000 Equity Shares of ₹ 5 each ₹ 4 per share called up	1,60,000
As on 31-12-2014	*₹*
1. Share Capital	
Authorised:	
2,000 Equity Shares of ₹ 100 each	2,00,000
Issued and Subscribed:	
20,000 Equity Shares of ₹ 100 each ₹ 80 per share called up	1,60,000

Note: Some accountants prefer not to make any entry as the amount remains same. Even when an entry is passed it applies only to the called up portion, and not to uncalled or unissued portion of share capital.

Conversion of Fully Paid Shares into Stock and Stock into Shares

Stock is the consolidation of the share capital into one unit divisible into aliquot parts. While it is impossible of the share capital to be one share, any amount of stock may be transferred. In practice, however, companies restrict the transfer of stock to multiples of, say, ₹ 100. A company can convert its fully paid shares into stock. Upon the company converting its shares into stock, the book-keeping entries merely record the transfer from share capital account to stock account. A separate Stock Register is started in which details of members' holdings are entered and the annual return is modified accordingly.

Illustration 2

C Ltd. had ₹ 5,00,000 authorised capital on 31-12-2012 divided into shares of ₹ 100 each out of which 4,000 shares were issued and fully paid up. In June 22013 the Company decided to convert the issued shares into stock. But in June, 2014 the Company re-converted the stock into shares of ₹ 10 each, fully paid up.

Pass entries and show how Share Capital will appear in Notes to Balance Sheet as on 31-12-2012, 31-12-2013 and 31-12-2014.

Solution

Journal Entries

2013			₹	₹
June	Equity Share Capital A/c	Dr.	4,00,000	
	To Equity Stock A/c			4,00,000
	(Being conversion of 4,000 fully paid Equity Shares of ₹ 100 into ₹ 4,00,000 Equity Stock as per resolution in general meeting dated…)			
2014				
June	Equity Stock A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Being re-conversion of ₹ 4,00,000 Equity Stock into 40,000 shares of ₹ 10 fully paid Equity Shares as per resolution in General Meeting dated...)			

Notes to Balance Sheet

Liabilities :	
As on 31-12-2012	₹
1. Share Capital	
Authorised	
5,000 Equity Shares of ₹ 100 each	5,00,000
Issued and Subscribed	
4,000 Equity Shares of ₹ 100 each fully called up	4,00,000
As on 31-12-2013	₹
1. Share Capital	
Authorised	

5,000 Equity Shares of ₹ 100 each	5,00,000
Issued and Subscribed	
Equity Stock-4,000 Equity Shares of ₹ 100 converted into Stock	4,00,000
As on 31-12-2014	₹
1. Share Capital	
Authorised	
50,000 Equity Shares of ₹ 10 each	5,00,000
Issued and Subscribed	
40,000 Equity Shares of ₹ 10 each fully called up	4,00,000

2.2 Variation of Shareholders Rights

When a company has issued different classes of shares with different rights or privileges attached to such shares e.g. rights as to dividend, voting rights etc. any of such right may be changed in any manner.

For example, the company may change rate of (a) dividend on preference shares or (b) convert cumulative preference shares into non-cumulative preference shares without changing the amount of share capital by passing the following journal entries:

(a) Debit (Old)% Cum. Pref. Share Capital Account
Credit (New)% Cum. Pref. Share Capital Account

(b) Debit ...% Cum. Pref. Share Capital Account
Credit ...% Non-cum. Pref. Share Capital Account

2.3 Reduction of Share Capital

Section 100 of the Companies Act, 1956* lays down the procedure in respect of reduction of share capital. One way of doing this is reducing the paid-up capital. The share capital of a company which has been suffering losses continuously for a long time, is not truly represented by its assets. In such a case, any scheme for capital reduction should write-off that portion of capital which is already lost.

This reduction is a sacrifice by the shareholders and the amount of reduction or sacrifice is credited to a new account called Capital Reduction Account (or Reconstruction Account). The accounting treatment is as follows:

* Corresponding Section 66 (Reduction of Share Capital) of the Companies Act, 2013 has not been notified till 31st May, 2015.

Reduction in paid up value only- Here the nominal value of the share remains the same and only the paid value is reduced. For example, the shareholders may agree to reduce the paid capital of ₹ 100 per share to paid value of ₹ 10 per share. The sacrifice is ₹ 90 and the entry will be

Share Capital Account	Dr.	(₹ 90 X No. of Shares)
To Capital Reduction Account		(₹ 90 X No. of Shares)

Reduction in both nominal and paid up values- In this case, both the paid up capital and nominal value of the shares are reduced. Continuing the above example, the entry will be:

Share Capital Account (₹ 100 Share)	Dr.	(₹ 100 X No. of Shares)
To Share Capital (₹ 10 Share)		(₹ 10 X No. of Shares)
To Capital Reduction Account		(₹ 90 X No. of Shares)

Thus in such treatment we debit the original Share Capital Account so as to close it, credit new Share Capital Account with the amount treated as paid up; and credit Capital Reduction Account with the difference. A certified copy of Court's order and Minutes approved by the Court must be filed by the Registrar.

2.4 Compromise/Arrangements

A scheme of compromise and arrangement is an agreement between a company and its members and outside liabilities when the company faces financial problems. Such an arrangement therefore also involves sacrifices by shareholders, or creditors and debenture holders or by all.

Accounting treatment for some of the cases is as follows:

a) When equity shareholders give up there claim to reserves and accumulated profits:

Reserves Account	Dr.	(With the amount of
To Reconstruction Account		reserves)

b) Settlement of outside liabilities at lesser amount: Liabilities such as sundry creditors may agree to accept less amount in lieu of final settlement. Treatment will be as follows:

Outside Liabilities Account	Dr.	(With the amount of sacrifice
Provision Account, if any	Dr.	made by creditors, debenture
To Reconstruction Account		holders etc.)

2.5 Surrender of Shares

The shareholders are made to surrender their shares. These shares are then allotted to debenture holders and creditors so that their liabilities are reduced. The unutilized surrendered shares are then cancelled.

3. Entries in Case of Internal Reconstruction

On a scheme of reconstruction being adopted (through special resolution confirmed by the Court), the entries to be passed are:

1. An appreciation in the value of an asset or reduction in the amount of a liability should be debited to the account concerned and credited to Capital Reduction Account (or Reconstruction Account).
2. Write off all fictitious assets (including Goodwill and Patents) and eliminate all over-valuation of assets by crediting the accounts concerned and debiting the Capital Reduction (or Reconstruction) Account. For this purpose, any reserve appearing in the books of the company may be used. If any balance is left in the Capital Reduction (or Reconstruction) Account it should be transferred to the Capital Reserve Account.

While preparing the balance sheet of a reconstructed company, the following points are to be kept in mind:

(*a*) After the name of the company, the words **"and Reduced"** should be added *only* if the Court so orders.

(*b*) In case of fixed assets, the amount written off under the scheme of reconstruction must be shown for five years.

Illustration 3

Following is the Draft Balance Sheet of ABC Ltd. Co. as at 31st March, 2015:

Liabilities	₹	*Assets*	₹
Share capital:		*Plant and machinery*	*9,00,000*
2,00,000 Equity shares of		*Furniture and fixtures*	*2,50,000*
₹ 10 each fully paid up	*20,00,000*	*Patents and copyrights*	*70,000*
6,000 8% Preference shares of ₹ 100 each	*6,00,000*	*Investments (at cost) (Market value ₹ 55,000)*	*68,000*
9% Debentures	*12,00,000*	*Inventory*	*14,00,000*
Bank overdraft	*1,50,000*	*Trade receivables*	*14,39,000*
Trade payables	*5,92,000*	*Cash and bank balance*	*10,000*

		Profit and Loss Account	*4,05,000*
	45,42,000		*45,42,000*

The following scheme of reconstruction was finalized:

(i) *Preference shareholders would give up 30% of their capital in exchange for allotment of 11% Debentures to them.*

(ii) *Debentureholders having charge on plant and machinery would accept plant and machinery in full settlement of their dues.*

(iii) Inventory *equal to ₹ 5,00,000 in book value will be taken over by trade payables in full settlement of their dues.*

(iv) *Investment value to be reduced to market price.*

(v) *The company would issue 11% Debentures for ₹ 3,00,000 to augment its working capital requirement after settlement of bank overdraft.*

Give necessary journal entries reflecting the above scheme of reconstruction in the books of the ABC Ltd. Co.

Solution

Journal Entries in the Books of ABC Ltd.

Particulars		₹	₹
8% Preference share capital A/c	Dr.	6,00,000	
To Preference shareholders A/c			4,20,000
To Capital reduction A/c			1,80,000
[Being 30% reduction in liability of preference share capital]			
Preference shareholders A/c	Dr.	4,20,000	
To 11% Debentures A/c			4,20,000
[Being the issue of debentures to preference shareholders]			
9% Debentures A/c	Dr.	12,00,000	
To Debenture holders A/c			12,00,000
[Being transfer of 9% debentures to debenture holders A/c]			
Debenture holders A/c	Dr.	12,00,000	
To Plant & machinery A/c			9,00,000
To Capital reduction A/c			3,00,000
[Settlement of debenture holders by allotment of plant & machinery]			
Trade payables A/c	Dr.	5,92,000	

To Inventory A/c			5,00,000
To Capital reduction A/c			92,000
[Being settlement of creditors by giving stocks]			
Bank A/c	Dr.	3,00,000	
To 11% Debentures A/c			3,00,000
[Being fresh issue of debentures]			
Bank overdraft A/c	Dr.	1,50,000	
To Bank A/c			1,50,000
[Being settlement of bank overdraft]			
Capital reduction A/c	Dr.	4,18,000	
To Investment A/c			13,000
To Profit and loss A/c			4,05,000
(Being decrease in investment and profit and loss account (Dr. bal.); transferred to capital reduction)			
Capital reduction A/c	Dr.	1,54,000	
To Capital reserve A/c			1,54,000
(Balance of capital reduction account transferred to capital reserve]			

Illustration 4

The Balance Sheet of A & Co. Ltd. as on 31-12-2014 is as follows:

Assets	₹	₹
Fixed Assets:		
Freehold property	*4,25,000*	
Plant	*50,000*	
Patent	*37,500*	
Goodwill	*1,30,000*	*6,42,500*
Traded Investments (at cost)		*55,000*
Current Assets:		
Trade receivables	*4,85,000*	
Inventory	*4,25,000*	*9,10,000*
Profit and Loss Account		*5,35,000*
Total		*21,42,500*

Liabilities		
Share Capital:		
4,000 6% Cumulative Preference Shares of ₹ 100 each	*4,00,000*	
75,000 Equity Shares of ₹ 10 each	*7,50,000*	*11,50,000*
6% Debentures (Secured on Freehold Property)	*3,75,000*	
Accrued Interest	*22,500*	*3,97,500*
Current Liabilities:		
Bank Overdraft	*1,95,000*	
Trade payables	*3,00,000*	
Directors' Loans	*1,00,000*	*5,95,000*
Total		*21,42,500*

The Court approved a Scheme of re-organisation to take effect on 1-1-2014, whereby:

(i) The Preference shares to be written down to ₹ 75 each and Equity Shares to ₹ 2 each.

(ii) Of the Preference Share dividends which are in arrears for four years, three fourths to be waived and Equity Shares of ₹ 2 each to be allotted for the remaining quarter.

(iii) Accrued interest on debentures to be paid in cash.

(iv) Debenture-holders agreed to take over freehold property, book value ₹ 1,00,000 at a valuation of ₹ 1,20,000 in part repayment of their holdings and to provide additional cash of ₹ 1,30,000 secured by a floating charge on company's assets at an interest rate of 8% p.a.

(v) Patents and Goodwill to be written off.

(vi) Inventory to be written off by ₹ 65,000.

(vii) Amount of ₹ 68,500 to be provided for bad debts.

(viii) Remaining freehold property to be re-valued at ₹ 3,87,500.

(ix) Trade Investments be sold for ₹ 1,40,000.

(x) Directors to accept settlement of their loans as to 90% thereof by allotment of equity shares of ₹ 2 each and as to 5% in cash, and balance 5% being waived.

(xi) There were capital commitments totalling ₹ 2,50,000. These contracts are to be cancelled on payment of 5% of the contract price as a penalty.

(xii) Ignore taxation and cost of the scheme.

You are requested to show Journal entries reflecting the above transactions (including cash transactions) and prepare the Balance Sheet of the company after completion of the Scheme.

Solution

Journal of A & Co. Ltd.

			Dr.	Cr.
			₹	₹
2014	Equity Share Capital A/c (₹ 10)	Dr.	7,50,000	
Dec. 31	To Capital Reduction A/c			6,00,000
	To Equity Share Capital A/c (₹ 2)			1,50,000
	(Reduction of equity shares of ₹ 10 each to shares of ₹ 2 each as per Reconstruction Scheme dated...)			
	6% Cum. Preference Share Capital A/c (₹ 100)	Dr.	4,00,000	
	To Capital Reduction A/c			1,00,000
	To Pref. Share Capital A/c (₹ 75)			3,00,000
	(Reduction of preference shares of ₹ 100 each to shares of ₹ 75 each as per reconstruction scheme)			
2014	Freehold Property A/c	Dr.	82,500	
Dec. 31	To Capital Reduction A/c			82,500
	(Appreciation in the value of property: Book value / Revalued Figure ₹ 1,00,000 / ₹ 1,20,000 ₹ 3,25,000 / ₹ 3,87,500 Total ₹ 4,25,000 / ₹ 5,07,500 Profit on revaluation: ₹ 82,500)			
”	6% Debentures A/c	Dr.	1,20,000	
	To Freehold Property A/c			1,20,000
	(Claims of debenture-holders, in part, in respect of principal discharged by transfer of freehold property vide Scheme of Reconstruction)			
	Accrued Interest A/c	Dr.	22,500	
	To Bank A/c			22,500
	(Debenture interest paid)			
”	Bank A/c	Dr.	1,30,000	
	To 8% Debentures A/c			1,30,000
	(8% Debentures issued for cash)			
”	Bank A/c	Dr.	1,40,000	

	To Trade Investment A/c			55,000
	To Capital Reduction A/c			85,000
	(Sale of Trade Investment for ₹ 1,40,000 cost being ₹ 55,000; profit credited to Capital Reduction Account)			
”	Directors' Loan A/c	Dr.	1,00,000	
	To Equity Share Capital A/c			90,000
	To Bank A/c			5,000
	To Capital Reduction A/c			5,000
	(Directors' loan discharged by issue of equity shares of ₹ 90,000, cash payments of ₹ 5,000 and surrender of ₹ 5,000, vide Scheme of Reconstruction)			
Dec. 31	Capital Reduction Account	Dr.	24,000	
	To Equity Share Capital Account			24,000
	(Arrears of preference dividends satisfied by the issue of equity shares, 25% of the amount due, ₹ 96,000)			
”	Capital Reduction A/c	Dr.	8,48,500	
	To Patents			37,500
	To Goodwill			1,30,000
	To Inventory			65,000
	To Provision for Doubtful Debts			68,500
	To Bank			12,500
	To Profit & Loss Account			5,35,000
	(Writing off patents, goodwill, profit and loss account and reducing the value of stock, making the required provision for doubtful debts and payment for cancellation of capital commitments)			

Balance Sheet of A & Co. Ltd. (And Reduced) as on 1st January, 2015

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	5,64,000
2		**Non-current liabilities**		
	a	Long-term borrowings	2	3,85,000

3		**Current liabilities**		
	a	Trade Payables		3,00,000
	b	Short term provision	**3**	68,500
		Total		**13,17,500**
		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	4	4,37,500
		Intangible assets	5	-
2		**Current assets**		
	a	Inventories		3,60,000
	b	Trade receivables	6	4,85,000
	c	Cash and cash equivalents		35,000
		Total		**13,17,500**

Notes to accounts

1	**Share Capital**		
	Equity share capital 1,32,000 Equity shares of ₹ 2 each (of the above 45,000 shares have been issued for consideration other than cash)		2,64,000
	Preference share capital		
	4,000 6% Preference shares of ₹ 75 each		3,00,000
	Total		**5,64,000**
2	**Long-term borrowings**		
	Secured		
	6% Debentures		2,55,000
	8% Debentures		1,30,000
	Total		**3,85,000**
3	**Short term provision**		
	Provision for doubtful debt		68,500
4	**Tangible assets**		
	Fixed assets		
	Tangible assets		

	Freehold property	4,25,000	
	Add: Appreciation under scheme of Reconstruction	82,500	
	Less: Disposed of	(1,20,000)	3,87,500
	Plant		50,000
	Patents	37,500	
	Less: Written off under scheme of Reconstruction	(37,500)	-
	Net carrying value		**4,37,500**
5	**Intangible assets**		
	Goodwill	1,30,000	
	Less: Written off under scheme of Reconstruction	(1,30,000)	
	Net carrying value	-	-
6	**Trade receivables**		
	Trade receivables		4,85,000

Illustration 5

Given below is the summarized balance sheet of Rebuilt Ltd. as on 31.3.2015:

Liabilities	*Amount ₹*	*Assets*	*Amount ₹*
Authorised and issued capital:		*Building at cost less depreciation*	*4,00,000*
12,000, 7% Preference shares of ₹ 50 each(Note: Preference dividend is in arrear for five years)	*6,00,000*	*Plant at cost less depreciation*	*2,68,000*
15,000 Equity shares of ₹ 50 each	*7,50,000*	*Trademarks and*	
	13,50,000	*goodwill at cost*	*3,18,000*
Loan	*5,73,000*	*Inventory*	*4,00,000*
Trade payables	*2,07,000*	*Trade receivables*	*3,28,000*
Other liabilities	*35,000*	*Profit and loss A/c*	*4,51,000*
	21,65,000		*21,65,000*

The Company is now earning profits short of working capital and a scheme of reconstruction has been approved by both the classes of shareholders. A summary of the scheme is as follows:

(a) The equity shareholders have agreed that their ₹ 50 shares should be reduced to ₹ 2.50 by cancellation of ₹ 47.50 per share. They have also agreed to subscribe for three new equity shares of ₹ 2.50 each for each equity share held.

(b) The preference shareholders have agreed to cancel the arrears of dividends and to accept for each ₹ 50 share, 4 new 5% preference shares of ₹ 10 each, plus 6 new equity shares of ₹ 2.50 each, all credited as fully paid.

(c) Lenders to the company for ₹ 1,50,000 have agreed to convert their loan into share and for this purpose they will be allotted 12,000 new preference shares of ₹ 10 each and 12,000 new equity shares of ₹ 2.50 each.

(d) The directors have agreed to subscribe in cash for 40,000, new equity shares of ₹ 2.50 each in addition to any shares to be subscribed by them under (a) above.

(e) Of the cash received by the issue of new shares, ₹ 2,00,000 is to be used to reduce the loan due by the company.

(f) The equity share capital cancelled is to be applied:

i. to write off the debit balance in the profit and loss A/c; and

ii. to write off ₹ 35,000 from the value of plant.

Any balance remaining is to be used to write down the value of trademarks and goodwill.

Show by journal entries how the financial books are affected by the scheme and prepare the balance sheet of the company after reconstruction. The nominal capital as reduced is to be increased to ₹ 6,50,000 for preference share capital and ₹ 7,50,000 for equity share capital.

Solution

In the books of Rebuilt Ltd.

Journal Entries

	Particulars		*Debit (₹)*	*Credit (₹)*
1.	Equity share capital A/c (₹ 50)	Dr.	7,50,000	
	To Equity share capital A/c (₹ 2.50)			37,500
	To Capital reduction A/c			7,12,500
	(Being equity capital reduced to nominal value of ₹ 2.50 each)			
2.	Bank A/c	Dr.	1,12,500	
	To Equity share capital			1,12,500
	(Being 3 right shares against each share was issued and subscribed)			
3.	7% Preference share capital A/c (₹ 50)	Dr.	6,00,000	
	Capital reduction A/c	Dr.	60,000	

	To 5% Preference share capital (₹ 10)			4,80,000
	To equity share capital (₹ 50)			1,80,000
	(Being 7% preference shares of ₹ 50 each converted to 5% preference shares of ₹ 10 each and also given to them 6 equity shares for every share held)			
4.	Loan A/c	Dr.	1,50,000	
	To 5% Preference share capital A/c			1,20,000
	To Equity share capital A/c			30,000
	(Being loan to the extent of ₹ 1,50,000 converted into share capital)			
5.	Bank A/c	Dr.	1,00,000	
	To Equity share application money A/c			1,00,000
	(Being shares subscribed by the directors)			
6.	Equity share application money A/c	Dr.	1,00,000	
	To Equity share capital A/c			1,00,000
	(Being application money transferred to capital A/c)			
7.	Loan A/c	Dr.	2,00,000	
	To Bank A/c			2,00,000
	(Being loan repaid)			
8.	Capital reduction A/c	Dr.	6,52,500	
	To Profit and loss A/c			4,51,000
	To Plant A/c			35,000
	To Trademarks and Goodwill A/c (Bal.fig.)			1,66,500
	(Being losses and assets written off to the extent required)			

Balance sheet of Rebuilt Ltd. (and reduced)

as on 31.3.2015

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	10,60,000
2		**Non-current liabilities**		
	a	Long-term borrowings		2,23,000

3		**Current liabilities**		
	a	Trade Payables		2,07,000
	b	Other current liabilities		35,000
		Total		**15,25,000**
		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	2	6,33,000
		Intangible assets	3	1,51,500
2		**Current assets**		
	a	Inventories		4,00,000
	b	Trade receivables		3,28,000
	c	Cash and cash equivalents	4	12,500
		Total		**15,25,000**

Notes to accounts

			₹
1	**Share Capital**		
	Authorised capital:		
	65,000 Preference shares of ₹ 10 each	6,50,000	
	3,00,000 Equity shares of ₹ 2.50 each	7,50,000	14,00,000
	Issued, subscribed and paid up:		
	1,80,000 equity shares of ₹ 2.5 each	4,60,000	
	60,000, 5% Preference shares of ₹ 10 each	6,00,000	10,60,000
2	**Tangible assets**		
	Building at cost less depreciation	4,00,000	
	Plant at cost less depreciation	2,33,000	6,33,000
3.	**Intangible assets**		
	Trademarks and goodwill		1,51,500
4	**Cash and cash equivalents**		
	Bank (1,12,500+1,00,000-2,00,000)		12,500

Illustration 6

Repair Ltd. is in the hands of a receiver for debenture holders who holds a charge on all assets except uncalled capital. The following statement shows the position as regards creditors as on 30th June, 2015:

Liabilities	₹	Assets	₹
6,000 shares of ₹ 60 each,		Property, machinery	
₹ 30 paid up		and plant etc. (Cost	
First debentures	3,00,000	₹ 3,90,000)	
Second debentures	6,00,000	Estimated at	1,50,000
Unsecured trade payables	4,50,000	Cash in hand of	
		the receiver	2,70,000
		Charged under debentures	4,20,000
		Uncalled capital	1,80,000
			6,00,000
		Deficiency	7,50,000
	13,50,000		13,50,000

A holds the first debentures for ₹ 3,00,000 and second debentures for ₹ 3,00,000. He is also an unsecured creditor for ₹ 90,000. B holds second debentures for ₹ 3,00,000 and is an unsecured trade payables for ₹ 60,000.

The following scheme of reconstruction is proposed:

1. *A is to cancel ₹ 2,10,000 of the total debt owing to him, to bring ₹ 30,000 in cash and to take first debentures (in cancellation of those already issued to him) for ₹ 5,10,000 in satisfaction of all his claims.*
2. *B is to accept ₹ 90,000 in cash in satisfaction of all claims by him.*
3. *In full settlement of 75% of the claim, unsecured creditors (other than A and B) agreed to accept four shares of ₹ 7.50 each, fully paid against their claim for each share of ₹ 60. The balance of 25% is to be postponed and to be payable at the end of three years from the date of Court's approval of the scheme. The nominal share capital is to be increased accordingly.*
4. *Uncalled capital is to be called up in full and ₹ 52.50 per share cancelled, thus making the shares of ₹ 7.50 each.*

Assuming that the scheme is duly approved by all parties interested and by the Court, give necessary journal entries.

Solution

Journal Entries

Particulars		*Debit* (*₹*)	*Credit* (*₹*)
First debentures A/c	Dr.	3,00,000	
Second debentures A/c	Dr.	3,00,000	
Unsecured creditors A/c	Dr.	90,000	
To A's A/c			6,90,000
(Being A's total liability ascertained)			
A's A/c	Dr.	2,10,000	
To Capital reduction A/c			2,10,000
(Being cancellation of debt upto ₹ 2,10,000)			
Bank A/c	Dr.	30,000	
To A's A/c			30,000
(Being cash received in course of settlement)			
A's A/c	Dr.	5,10,000	
To First debentures A/c			5,10,000
(Being liability of A, discharged against first debentures)			
Second debentures A/c	Dr.	3,00,000	
Unsecured creditors A/c	Dr.	60,000	
To B's A/c			3,60,000
(Being B's liability ascertained)			
B's A/c	Dr.	3,60,000	
To Bank A/c			90,000
To Capital reduction A/c			2,70,000
(Being B's liability discharged)			
Unsecured trade payables A/c	Dr.	3,00,000	
To Equity share capital A/c			1,12,500
To Loan (Unsecured) A/c			75,000
To Capital reduction A/c			1,12,500
(Being settlement of unsecured creditors)			

Share call A/c	Dr.	1,80,000	
To Share capital A/c			1,80,000
(Being final call money due)			
Bank A/c	Dr.	1,80,000	
To Share call A/c			1,80,000
(Being final call money received)			
Share capital A/c (Face value ₹ 60)	Dr.	3,60,000	
To Share capital (Face value ₹ 7.50)			45,000
To Capital reduction A/c			3,15,000
(Being share capital reduced to ₹ 7.50 each)			
Capital reduction A/c	Dr.	8,70,000	
To Profit and loss A/c			8,70,000
(Being reconstruction surplus used to write off losses)			

Working Notes:

1.	**Settlement of claim of remaining unsecured creditors**			₹
	75% of ₹ 3,00,000			2,25,000
	Considering their claim for share of ₹ 60 each			
	2,25,000/60 =3,750 shares			
	Less: Number of shares to be issued			
	3,750 x 4= 15,000 shares of ₹ 7.5 each			
	Total value= 15,000 x 7.50			(1,12,500)
	Transferred to Capital reduction A/c			1,12,500

2. Ascertainment of profit and loss account's debit balance at the time of reconstruction.

	₹	₹
Asset		
Fixed assets	3,90,000	
Cash	2,70,000	6,60,000
Less: Capital & Liabilities:		
Share capital	1,80,000	
1st Debenture	3,00,000	
2nd Debenture	6,00,000	
Unsecured *trade payables*	4,50,000	(15,30,000)
Profit and loss A/c (Debit balance)		(8,70,000)

Illustration 7

The Balance Sheet of Vaibhav Ltd. as on 31st March 2014 is as follows:

Liabilities	*₹*	*Assets*	*₹*
Equity Shares of ₹ 100 each	*2,00,00,000*	*Fixed Assets*	*2,50,00,000*
6%, Cumulative Preference Shares of ₹ 100 each	*1,00,00,000*	*Investments (Market Value ₹ 19,00,000)*	*20,00,000*
5% Debentures of ₹ 100 each	*80,00,000*	*Current Assets*	*2,00,00,000*
Sundry Creditors	*1,00,00,000*	*P & L A/c*	*12,00,000*
Provision for taxation	*2,00,000*		
TOTAL	*4,82,00,000*	*TOTAL*	*4,82,00,000*

The following scheme of Internal Reconstruction is sanctioned:

(i) All the existing equity shares are reduced to ₹ 40 each.

(ii) All preference shares are reduced to ₹ 60 each.

(iii) The rate of Interest on Debentures increased to 6%. The Debenture holders surrender their existing debentures of ₹ 100 each and exchange the same for fresh debentures of ₹ 70 each for every debenture held by them.

(iv) Fixed assets are to be written down by 20%.

(v) Current assets are to be revalued at ₹ 90,00,000.

(vi) Investments are to be brought to their market value.

(vii) One of the creditors of the company to whom the company owes ₹ 40,00,000 decides to forgo 40% of his claim. The creditor is allotted with 60000 equity shares of ₹ 40 each in full and final settlement of his claim.

(viii) The taxation liability is to be settled at ₹ 3,00,000.

(ix) It is decided to write off the debit balance of Profit & Loss A/c.

Pass journal entries and show the Balance Sheet of the company after giving effect to the above.

Solution

Journal Entries in the books of Vaibhav Ltd.

			₹	₹
(i)	Equity share capital (₹ 100) A/c	Dr.	2,00,00,000	
	To Equity Share Capital (₹ 40) A/c			80,00,000

	To Capital Reduction A/c		1,20,00,000
	(Being conversion of equity share capital of ₹ 100 each into ₹40 each as per reconstruction scheme)		
(ii)	6% Cumulative Preference Share capital (₹ 100) A/c Dr.	1,00,00,000	
	To 6% Cumulative Preference Share Capital (₹ 60)A/c		60,00,000
	To Capital Reduction A/c		40,00,000
	(Being conversion of 6% cumulative preference shares capital of ₹ 100 each into ₹ 60 each as per reconstruction scheme)		
(iii)	5% Debentures (₹ 100) A/c Dr.	80,00,000	
	To 6% Debentures (₹ 70) A/c		56,00,000
	To Capital Reduction A/c		24,00,000
	(Being 6% debentures of ₹ 70 each issued to existing 5% debenture holders. The balance transferred to capital reduction account as per reconstruction scheme)		
(iv)	Sundry Creditors A/c Dr.	40,00,000	
	To Equity Share Capital (₹ 40) A/c		24,00,000
	To Capital Reduction A/c		16,00,000
	(Being a creditor of ₹ 40,00,000 agreed to surrender his claim by 40% and was allotted 60,000 equity shares of ₹ 40 each in full settlement of his dues as per reconstruction scheme)		
(v)	Provision for Taxation A/c Dr.	2,00,000	
	Capital Reduction A/c Dr.	1,00,000	
	To Liability for Taxation A/c		3,00,000
	(Being conversion of the provision for taxation into liability for taxation for settlement of the amount due)		
(vi)	Capital Reduction A/c Dr.	199,00,000	
	To P & L A/c		12,00,000
	To Fixed Assets A/c		50,00,000
	To Current Assets A/c		110,00,000
	To Investments A/c		1,00,000

	To Capital Reserve A/c (Bal. fig.)		26,00,000
	(Being amount of Capital Reduction utilized in writing off P & L A/c (Dr.) Balance, Fixed Assets, Current Assets, Investments and the Balance transferred to Capital Reserve)		
(vii)	Liability for Taxation A/c Dr.	3,00,000	
	To Current Assets (Bank A/c)		3,00,000
	(Being the payment of tax liability)		

Balance Sheet of Vaibhav Ltd. (After Reconstruction) as on 31st March, 2014

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	164,00,000
	b	Reserves and Surplus	2	26,00,000
2		**Non-current liabilities**		
		Long-term borrowings	3	56,00,000
3		**Current liabilities**		
		Trade Payables(1,00,00,000 less 40,00,000)		60,00,000
		Total		3,06,00,000
		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	4	200,00,000
	b	Investments	5	19,00,000
2		**Current assets**	6	87,00,000
		Total		3,06,00,000

Notes to accounts

		₹
1. Share Capital		
Equity share capital		
Issued, subscribed and paid up		
2,60,000 equity shares of ₹ 40 each (of the above 60,000 shares have been issued for consideration other than cash)		1,04,00,000

	Preference share capital		
	Issued, subscribed and paid up		
	1,00,000 6% Cumulative Preference shares of ₹ 60 each		60,00,000
	Total		1,64,00,000
2.	**Reserves and Surplus**		
	Capital Reserve		26,00,000
3.	**Long-term borrowings**		
	Secured		
	6% Debentures		56,00,000
4.	**Tangible assets**		
	Fixed Assets	2,50,00,000	
	Adjustment under scheme of reconstruction	(50,00,000)	2,00,00,000
5.	**Investments**	20,00,000	
	Adjustment under scheme of reconstruction	(1,00,000)	19,00,000
6.	**Current assets**		
		2,00,00,000	
	Adjustment under scheme of reconstruction	110,00,000	
		90,00,000	
	Taxation liability paid	(3,00,000)	87,00,000

Working Note:

Capital Reduction Account

To Liability for taxation A/c	1,00,000	By Equity share capital	1,20,00,000
To P & L A/c	12,00,000	By 6% Cumulative preferences	
To Fixed Assets	50,00,000	Share capital	40,00,000
To Current assets	1,10,00,000	By 5% Debentures	24,00,000
To Investment	1,00,000	By Sundry creditors	16,00,000
To Capital Reserve (Bal. fig.)	26,00,000		
	2,00,00,000		2,00,00,000

Summary

1. Reconstruction is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered by reducing the paid up value of shares and/or varying the rights attached to different classes of shares.
2. Reconstruction account is a new account opened to transfer the sacrifice made by the shareholders for that part of capital which is not represented by lost assets.
3. Reconstruction account is utilized for writing-off fictitious assets, writing down over-valued fixed assets, recording new liability etc.
4. If some credit balance remains in the reconstruction account, the same should be transferred to the capital reserve account.
5. Methods of Internal reconstruction :
   - Alteration of share capital :
     - ✓ Sub-divide or consolidate shares into smaller or higher Denomination
     - ✓ Conversion of share into stock or vice-versa
   - Variation of shareholders' rights :
     - ✓ Only the specific rights are changed. There is no change in the amount of capital.
   - Reduction of share capital
   - Compromise, arrangements etc.
   - Surrender of Shares.